ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author:	Oropeza	Analyst:	Marion Mann DeJong	Bill Number:	AB 263
Related Bills:	See Legislative History	Telephone:	845-6979	Introduced Date:	02/04/2003
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Dividends Received Deduction/Ceridian Issue

SUMMARY

This bill would specify how to apply the tax statute allowing a deduction for dividends received from an insurance company after the statute was found unconstitutional in the *Ceridian* decision.

PURPOSE OF THE BILL

The purpose of the bill appears to be to resolve questions regarding how to apply the statute allowing a deduction for dividends received from an insurance company since that statue was found to be unconstitutional.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment. The bill specifies that it would apply to all taxable years ending on or after December 1, 1997.

POSITION

Pending.

Summary of Suggested Amendments

An amendment is needed to resolve the “Technical Consideration” discussed below. Department staff is available to assist the author with this amendment.

ANALYSIS

<u>BACKGROUND</u>

Generally, Section 24410 of the Revenue and Taxation Code (RTC) allowed only corporations domiciled in California to claim a deduction for dividends received from an insurance company subsidiary subject to the gross premiums tax. The amount deductible was limited according to a formula based upon the subsidiary’s gross receipts, payroll, and property within California.

On December 21, 2000, the California Court of Appeal ruled in *Ceridian Corp. v. Franchise Tax Board* (2000) 85 Cal App 4th 875 (modified 86 Cal App 4th 483), that the deduction for dividends received by corporations domiciled in California from insurance company subsidiaries was unconstitutional. The court also concluded that the provision was incapable of judicial reformation.

Board Position:			Department Director	Date
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FEDERAL/STATE LAW

Federal law allows a deduction for dividends received from a domestic corporation that is subject to income tax. Dividends received from insurance companies are treated in the same manner as other dividends under federal law. The deduction is subject to specific reductions and limitations. Generally, the amount of the deduction is determined by the percentage of the taxpayer's ownership in the corporation as follows:

- 100% of the deduction is allowed when received from a corporation that is a member of the same affiliated group (generally, 80% or more common ownership).
- 80% of the deduction is allowed when received from a corporation that is greater than 20% but less than 80% owned.
- 70% of the deduction is allowed when received from a corporation less than 20% owned.

Federal law does not allow a deduction for dividends received from a foreign corporation unless the foreign corporation is wholly owned and has only effectively connected U.S. source income. If a domestic corporation owns 10% or more of a foreign corporation, it can elect to receive a tax credit for taxes paid to the foreign country.

Existing state law (RTC Section 24402) allows a deduction for a portion of any dividends received that are paid out of income that was subject to either the franchise tax, the alternative minimum tax, or the corporation income tax in the hands of the paying corporation. The intent of this law is to avoid double taxation of corporate income at the corporate level. A Superior Court decision that this section is unconstitutional is currently under review at the appellate level (*Farmer Bros v. Franchise Tax Board*, Court of Appeal, 2nd District 160061).

Insurance companies are not subject to the California Corporation Tax Law. Instead they are subject to a Gross Premiums tax and therefore they are not eligible for the deduction provided for by RTC Section 24402. Instead they were allowed a deduction under Section 24410. That statute was reviewed in *Ceridian*. That statute allowed corporations commercially domiciled in California to deduct dividends received from an insurance company subsidiary operating in California that is subject to the gross premiums tax. The deduction was allowed if the parent corporation owned at least 80% of each class of stock of the insurance company. The deduction was based on the portion of the dividend attributable to California sources, determined by applying a special three-factor formula based upon the subsidiary's gross receipts, payroll, and property within California.

The purpose of Section 24410 was to provide relief from double taxation similar to the relief provided to general corporations under the dividends received deduction of Section 24402.

Existing state law (RTC Section 24425) disallows expenses allocable to income that is not included in the measure of tax. Expenses incurred to earn income are allocable to that income. Federal law has a similar provision. The most common type of income that is not included in the measure of tax is deductible dividend income. Department staff has interpreted this statute to require taxpayers to add back to earned income expenses related to the Section 24410 dividend deductions because the insurance company dividends were not included in the measure of tax. In *Appeal of Zenith National Insurance Corp.,* 98-SBE-001, Jan. 8, 1998, the Board of Equalization applied RTC Section 24425 to insurance dividends.

Ceridian Case

The taxpayer in *Ceridian* challenged the limitation on the deduction for dividends received from insurance company subsidiaries set forth in RTC Section 24410 on two constitutional grounds relating to discrimination against interstate commerce. First, Ceridian was denied the deduction because the corporation was domiciled outside of California. Second, Ceridian argued that it was unconstitutional to limit the deduction to dividends paid only from income arising from California activities.

The California Court of Appeal ruled that the deduction for dividends received by holding companies from insurance company subsidiaries under RTC Section 24410 is unconstitutional on both grounds. First, it violated the commerce clause by allowing a deduction for insurance company dividends only to corporations domiciled in California. Second, it violated the commerce clause because the amount of the deduction is limited according to a formula based on the subsidiary's gross receipts, payroll, and property within California.

There are differing views on the impact of the appellate court decision that RTC Section 24410 is unconstitutionally discriminatory. Generally, if provisions of a statute are found to be unconstitutional, the remaining provisions of the statute can be preserved if the unconstitutional portion can be stricken without affecting the other parts. If the remaining provisions cannot be saved, the statute is void as unenforceable. (*Kopp v. Fair Political Practices Comm*. (1995) 11 Cal. 4th 607, 641.)

Members of the business community argue that parts of the statute can be severed to allow a deduction to all corporations with respect to all dividends from insurance companies.

The Legislative Counsel of California issued an opinion on December 7, 2001, finding that Section 24410 is inoperative and unenforceable as a result of *Ceridian*. The Legislative Counsel concluded that the provisions of Section 24410 could not be severed to eliminate the unconstitutional provisions and leave a 100% deduction for dividends received from an insurance company subsidiary. Thus, no deduction would be allowed.

Department Policy After *Ceridian*

Department staff is implementing the *Ceridian* decision in a manner consistent with the Legislative Counsel opinion that no deduction is allowed.

For tax years ending prior to December 1, 1997, the normal four-year statute of limitations is now closed. The court in *Ceridian* held that the only relief possible in that circumstance is to grant refunds by allowing a deduction to all corporations for all dividends received from an 80% owned insurance subsidiary. The department will apply RTC Section 24425 to deny expenses related to earned income that was not included in the measure of tax.

For tax years ending on or after December 1, 1997, the department will disallow all Section 24410-dividend deductions. Denying the benefit to those corporations favored by the statute cures discrimination. This is a remedy held to be acceptable by the United States Supreme Court and is consistent with the department staff's view of RTC Section 19393. (The Superior Court in *Ceridian* rejected the department staff's view of RTC Section 19393, but the appellate court did not need to decide the issue.) The department staff believes this remedy is also consistent with the holding of the court in *Ceridian* that the statute could not be reformed. A corresponding adjustment will be made if the taxpayer added back to earned income expenses related to the Section 24410 dividend deductions as provided by Section 24425.

THIS BILL

This bill would amend Section 24410 to allow taxpayers that own 80% or more of a subsidiary engaged in an insurance business a deduction for an unspecified percentage of dividends received from that subsidiary. The deduction would be allowed regardless of whether the insurance company is engaged in business in California.

The bill would also specify that RTC Section 24425 does not apply to any expense related to Section 24410 dividends. Thus, taxpayers would no longer be required to add back to earned income expenses related to the Section 24410 dividends.

The bill would make the following legislative declarations:

- The amendments to Section 24410 are necessary in light of the uncertainty resulting from the *Ceridian* decision regarding whether a 100% dividends-received deduction is allowed or whether no deduction is available. The amendments represent a fair and equitable result for all concerned. And further, the amendments serve the public purpose in avoiding the unintended impairment of the ability of California-based insurance holding companies to compete nationally and the possible detrimental effect on the state economy.

- The retroactive application of the amendments to Section 24410 serve the public purpose and promotes sound tax policy by affording equitable tax relief to taxpayers that relied upon Section 24410 for dividends received deductions that may be in jeopardy.

- The amendment to Section 24410 that declares Section 24425 to be inapplicable to the dividends received deductions for tax years beginning on or after December 1, 1997, represents an integral part of the legislative resolution to the uncertainty created by the *Ceridian* decision, and accordingly furthers the same valid public purposes identified above.

- No inferences should be made with respect to the application of Section 24425 to the dividends received deduction for taxable years beginning before December 1, 1997.

- The tax treatment of insurance company dividends as provided by this bill is unrelated to and distinguishable from the tax treatment of the deduction of general corporate dividends under Section 24402 and the application of Section 24425 to those deductions.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would not significantly impact the department's programs and operations. However, this bill would impact cases that are currently pending before the Board of Equalization, see "Legal Impact" below.

TECHNICAL CONSIDERATION

The bill retains one aspect of prior law that could be problematic. Specifically, the deduction requires the insurance company to be "subject to tax imposed by Part 7 (commencing with Section 12001) of this division at the time of the payment." Part 7 is the gross premiums tax paid by insurance companies engaged in business in California. Consequently, the bill appears to be internally inconsistent since it also says, "whether or not the insurance company is engaged in business in California."

LEGISLATIVE HISTORY

AB 483 (Shelley, 2001/2002) would have allowed certain corporations a 100% deduction for dividends received from an insurance company subsidiary. AB 483 was held in the Senate Revenue and Taxation Committee.

AB 1569 (Shelley, 2001/2002) would have allowed all corporations a deduction for dividends received from an insurance company subsidiary. AB 1569 was held in the Assembly Revenue and Taxation Committee.

SB 1229 (Committee on Revenue and Taxation, Stats. 1999, Ch. 987) and SB 2171 (Committee on Revenue and Taxation, 1999/2000) both contained provisions to amend RTC Section 24410 to allow all corporations a deduction for dividends received from an insurance company subsidiary. SB 1125 (Polanco, 1999/2000) would have allowed corporations to deduct interest expense attributable to dividends that are received from an insurance company subsidiary and are excluded from income. SB 1229 was tied to SB 1125 so that if only SB 1229 were enacted, only technical changes would be made. SB 1125 was vetoed on October 10, 1999; thus, SB 1229 made only technical changes to RTC Section 24410. SB 2171 was held in the Senate Appropriations Committee.

OTHER STATES' INFORMATION

Information regarding how *Florida, Illinois, Massachusetts, Michigan, Minnesota*, and *New York* treat dividends received from insurance company subsidiaries could not be found. The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

Review of *Florida, Illinois*, and *New York* laws found the following general information regarding deductible dividends.

Under *Florida* and *Illinois* laws, corporate income is determined by making adjustments to federal taxable income. Thus, the corporation is allowed the federal dividends received deduction. Some modifications are made to federal amounts if the amounts include Internal Revenue Code Section 78 dividends or dividends from foreign subsidiaries.

Under *New York* law, the federal deduction for dividends received is not allowed. However, 50% of all dividends from corporations other than from subsidiaries that were used in computing federal taxable income are allowed as a deduction.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

<u>Revenue Estimate</u>

The revenue implications of this bill depend on whether the current baseline is a 100% deduction for dividends received from an insurance company subsidiary or no deduction is allowed.

It is assumed that current law does not provide a deduction for any taxpayer under RTC Section 24410. As the percentage of dividends received deduction is not yet specified in the bill, revenue losses for open (1997-2002) and ongoing tax years cannot be quantified at this time.

However, if the current baseline reflects a 100% deduction, there could be undetermined revenue gains.

LEGAL IMPACT

Currently, the industry and the department disagree regarding the application of RTC Section 24425 to insurance company dividends. The department contends that where a taxpayer claims a dividends received deduction for insurance company dividends, expenses incurred to receive income not included in the measure of tax should be disallowed under RTC Section 24425 (thereby preventing a double benefit). In contrast, the industry contends that application of RTC Section 24425 causes double taxation and should not apply.

This bill, sponsored by industry, would specify that Section 24425 does not apply. It would impact two cases currently on appeal at the Board of Equalization; one case with a California domiciled parent and the other with a parent domiciled in another state.

LEGISLATIVE STAFF CONTACT

Marion Mann DeJong	Brian Putler
Franchise Tax Board	Franchise Tax Board
845-6979	845-6333
marion.dejong@ftb.ca.gov	brian.putler@ftb.ca.gov